Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1971

No. ~~327~~ 71-327

TEXAS GULF SULPHUR COMPANY, a Texas corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, CLAUDE O. STEPHENS and HAROLD B. KLINE,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR REHEARING

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PETITION FOR REHEARING

Petitioners respectfully move this Court for an order (1) vacating its denial of their petition for writ of certiorari, entered on December 20, 1971, and (2) granting the petition. In support of this motion, petitioners state the following:

I

This petition may be considered by the full Court of nine Justices.

The petition for certiorari was denied on December 20, 1971, with Justices Stewart and Blackmun dissenting. Since that time, two new Justices have become members of this Court, and this landmark case may now be considered by the full Court*.

There can be no question as to the great public importance of the issues presented in this action. The significance of the case is evidenced by the plethora of books, law review articles and other commentaries regarding it, some of which are listed in Appendix A to the petition. On a previous occasion, Mr. Justice White dissented from the denial of certiorari with respect to one part of this case stating that the issues "are of general importance" (394 U.S. 976), and as previously noted, Justices Stewart and Blackmun dissented from the most recent denial. In addition, the petition for rehearing and petition for certiorari in *Texas Gulf Sulphur Co.* v. *Mitchell* (Docket No. 421) raise questions of private damage liability which are of great moment to publicly held corporations. We respect-

* While Rule 58(1) of this Court provides that a petition for rehearing of judgments or decisions other than those denying or granting certiorari "will not be granted, except at the instance of a justice who concurred in the judgment or decision and with the concurrence of a majority of the Court," no such restriction appears in subdivision (2) of Rule 58, relating to petitions for rehearing of denial of certiorari. Similarly, the practice for new Justices not to participate in the consideration of a petition for rehearing after decision on the merits would not seem to apply to consideration of a petition for rehearing of denial of certiorari. *Cf.* STERN & GRESSMAN, SUPREME COURT PRACTICE §§15.6 and 15.7 (4th ed. 1969).

fully request the entire Court to consider the points set forth in the petition for certiorari here and in *Mitchell* and to grant the petitions so that the issues involved in these landmark cases can be reviewed by this Court.

II

The entire thrust of SEC administration of the securities laws has been to discourage premature predictions and to encourage conservative evaluation of mining exploration results; it contravenes basic fairness to apply *ex post facto* contrary principles in this case.

The extent to which the SEC has heretofore encouraged a conservative approach in statements regarding mineral exploration was not sufficiently brought to the attention of this Court in the petition for certiorari. (See p. 26, note). This careful approach has appeared in, and has indeed pervaded, regulations promulgated by the SEC almost from the inception of its administration of the securities laws; in administrative decisions under these laws; in interpretative press releases; and in *amicus* briefs filed by the SEC in other cases. Such a careful approach is in accord with all treatises and teaching in the fields of geology and mining.

The geologists and mining engineers who comprised the management of Texas Gulf and who prepared the April 12 press release had been, over the years, conditioned, as had the whole business community (perhaps to a lesser extent) by the enforced conservative approach of the SEC to exploration results. Nevertheless, Texas Gulf mining

experts have been *ex post facto* condemned by the Second Circuit and, on remand, by the District Court, for not being publicly exuberant about the results from just three completed 1⅛ inch drill holes, only one of which had been chemically assayed. The essential unfairness of this approach is another ground for grant of the petition for certiorari.

The basic provision adopted by the SEC with respect to disclosure of mining exploration results is contained in Schedule I to Form 1-A relating to Regulation A Offerings under the Securities Act of 1933:

> "[n]o claim shall be made as to the existence of a body of ore unless it has been sufficiently tested to be properly classified as 'proven' or 'probable' ore, as defined below. If the work done has not established the existence of proven or probable ore, a statement shall be made that no body of commercial ore is known to exist on the property." Item 8A(b)

"Proven" and "probable" ore have always been defined by the SEC as follows:

> "(c) The term 'proven ore' means a body of ore so extensively sampled that the risk of failure in continuity of the ore in such body is reduced to a minimum. The term 'probable ore' means ore as to which the risk of failure in continuity is greater than for proven ore, but as to which there is sufficient warrant for assuming continuity of the ore." Item 8A(c)

The SEC regularly applies these provisions to registration statements under the 1933 Act as well as to proxy materials under the 1934 Act. Extensive supporting data is required before the Commission will permit statements indicating that exploratory results are of commercial significance.

Numerous administrative decisions of the SEC have confirmed this conservative approach. Thus in *Pan-American Gold Ltd.*, 31 S.E.C. 141, 147-48 (1950), the Commission stated that:

> "* * * three diamond drill holes are insufficient to determine whether a commercial ore body is present, even though they should encounter a gold-bearing structure."

In *National Lithium Corp.*, 40 S.E.C. 746 (1961), the Commission held that estimates of ore reserves included in a geologist's report as an exhibit to a Registration Statement were materially misleading because the geologist had not sufficiently investigated the economic factors which would determine the profitability of the proposed operation, such as availability of markets and mining, milling and transportation costs. In addition, the Commission concluded that:

> "* * * the record establishes that the 26 drill holes [in certain areas] were insufficient to support * * * reserve estimates [for those areas] * * *." *Id.* at 755

The SEC's administrative emphasis on caution is not confined to the mining areas. Thus in the *Report of the Special Study of the Securities Market of the Securities and Exchange Commission*, H. R. Doc. No. 95, Pt. 3, 88th Cong., 1st Sess., 1963, the Commission stated:

> "Overenthusiastic or premature publicity concerning product developments constitutes another potential abuse." *Id.* at 91.

The SEC report went on to describe as illustrative of possible abuse, a corporate announcement of a scientific development made in May, 1960 and noted that "by the Spring of 1962, the plant was not yet in operation. * * *" *Id.* at 92.

The New York Stock Exchange in its *Company Manual* also provided in 1964 that "premature announcements of new products whose commercial applications cannot yet be determined realistically, overly optimistic forecasts, exaggerated claims, and unwarranted promises should be avoided." *Id.* at A-20.

It was against this background of nearly thirty years of enforcement of the securities laws that the April 12, 1964, press release was drafted.

With only three 1⅛ inch drill holes completed, Texas Gulf in April, 1964, was clearly acting responsibly* in shunning premature claims when further drilling might well have shown that the strike had little or no commercial significance to a company with 10,000,000 outstanding shares, with annual sales in 1963 of more than $62,000,000 and earnings of more than $9,000,000, and with working capital of almost $47,000,000. Accordingly, the Texas Gulf mining engineers who prepared the release issued on Sunday, April 12, 1964, stated, in response to published rumors, both exaggerated and false, that no definite conclusions could be made until further drilling was completed. The release promised a clarifying public statement as soon as responsible conclusions could be drawn.

Texas Gulf's press release of April 12, 1964, as initially determined by the District Judge who heard and saw the witnesses, was issued in the exercise of reasonable business judgment and fully conformed with the standards theretofore insisted upon by the SEC and the New York Stock Exchange.

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* Six of the nation's leading independent experts so testified and Judge Bonsal so found after a four-week trial.

III

Shifting the burden of proof from the SEC to Texas Gulf after trial was unwarranted and unfair.

On the original trial Judge Bonsal found on the evidence that the SEC had failed to establish that the April 12 release was false or misleading. On remand, however, and over Texas Gulf's objection, the District Judge felt constrained by the majority opinion of the Court of Appeals to receive the testimony of former Texas Gulf stockholders who said that they had been discouraged by the release and had therefore sold their shares. Other stockholders, who the Court found were equally reasonable investors, testified that they were encouraged by the release either to buy or hold Texas Gulf shares. Although the burden of proof should have rested on the SEC as plaintiff, the courts below have concluded that since *some* persons claimed to have sold their shares because of the release, the release was therefore misleading.* Thus was the burden of proof shifted from plaintiff to defendant and, in order to prevail, Texas Gulf, was in effect required to show that no selling stockholder had been influenced by the release.

The courts below also shifted the burden of proof on another important aspect. Rather than requiring the SEC to prove fraud or even negligence on the part of Texas

* The District Court on remand held that the press release was misleading on the basis of the following finding:

> "All of the shareholders appear to have been reasonable investors as that term has been defined by the Court of Appeals, and all were influenced by the press release, some selling their shares, and others holding their shares or purchasing shares." 312 F. Supp. at 83.

Gulf, the company was required to prove its own "due diligence", *i.e.*. to prove that it was not negligent. Despite having satisfied the trial court, which initially found that Texas Gulf had exercised reasonable business judgment in drafting and issuing the release, the company was nevertheless required to prove something more to obtain exoneration.

The implications of the procedure followed by the courts below are alarming indeed. The same news item may persuade some investors or speculators to sell shares while others will buy. If subsequent events suggest that a class of investors took the wrong course, the disappointed class might well be able to claim against the issuer of the news item and its stockholders. What the defendant must prove to avoid such liability remains shrouded in confusion.

IV

Creation and application of a new and unique standard of materiality under Section 10(b) was unfair to petitioners and is totally unworkable in the context of the securities laws.

In a footnote on page 36 of its brief in opposition to the petition appeared a remarkable concession by the SEC, a concession which was necessary in order to justify the decision below but which was nevertheless contrary to the SEC's administration of the securities laws for the past 37 years. Perhaps because of its appearance in a brief in opposition and in a footnote, this concession did not receive the notice and attention which it deserves. The footnote in effect contends that the definition of "materiality"

which the SEC has promulgated under all the securities laws it administers does not apply to Section 10(b) and Rule 10b-5! Yet since 1934 the Commission's definition of a "material" fact has consistently been as provided in Rule 12b-2(j) under the 1934 Act:

> "The term 'material' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before buying or selling the security registered." Rule 12b-2(j) (17 C.F.R. §240.12b-2(j)).*

If, as the Commission now argues, the standard of materiality under Rule 10b-5 is indeed lower than that applicable to the remainder of the securities laws, then the Commission's regulations and the specific disclosure requirements of the securities laws would serve only to entrap those who comply with their terms.

The definition of materiality which the Second Circuit found necessary to adopt at the urging of the SEC in order to justify the result below, contrary to the SEC's definition of 37 years standing, has been widely, and currently, criticized. Thus, most recently, Professor William Painter, a leading authority on the securities laws, writing in November, 1971, states that if the Second Circuit's test is to be taken literally, it

> "* * * becomes so broad as to be nearly unworkable. Rumors and guesses, educated or otherwise, motivate

* See also the identical substantive test in Rule 210.1002(g) (17 C.F.R. §210.1-02(g)) of Regulation S-X which governs all financial statements filed under the securities laws; Rule 405 (17 C.F.R. §230.405(1)) of Regulation C under the 1933 Securities Act; and Rule 8b-2 (17 C.F.R. §270.8b-2) under the Investment Company Act of 1940 (15 U.S.C. §80a-1).

> the speculator, as well as what could only be described as the mood of the moment and crowd psychology. To impose an affirmative duty to disclose all that might be relevant to speculators, chartists and others would seem to condone if not encourage the type of premature release of unreliable or unripe facts which it would be wiser to withhold. * * *'' Painter, *Rule 10b-5: The Recodification Thicket,* 45 ST. JOHN'S L. REV. 699, 710-11 (1971).

He further points out that the Second Circuit test

> "* * * seems highly conceptual if not impossible for the average insider to use as any sort of a practical guideline. In the final analysis, it may come down to little more than saying that materiality depends upon the facts of each case, retroactively determined by the particular court in which you happen to be sued, acting with the benefit of hindsight." *Id.* at 711.

The fact is that the Second Circuit fell into obvious error in announcing that a fact is material under Rule 10b-5 if it "may" be of interest to a speculator or "might" affect the market price of a security, even though that same fact would not be material, under existing SEC regulations, for inclusion in a proxy or registration statement.* Such are the rules by which lawyers are now expected to advise their clients. Surely the public is entitled to better guidance than tests as elusive and contradictory as these. The case at bar presents appropriate facts for this Court to deal with these important questions.

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* Just this week this Court has in effect instructed the SEC to proceed by administrative or legislative means, not by judicial proceedings, if it seeks to change the long-standing prohibitions of the 1934 Act. *Reliance Electric Company* v. *Emerson Electric Company,* 40 U.S.L.W. 4125 (U.S. Jan. 11, 1972).

Conclusion

For these reasons, as well as those contained in the petition for a writ of certiorari herein and in *Texas Gulf Sulphur Co.* v. *Mitchell* (No. 421) petitioners pray that this Court grant rehearing of both petitions and order a review of the judgments and opinions below.

Dated: January 14, 1972

Respectfully submitted,

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As counsel for the petitioners, I hereby certify that the petition for rehearing is presented in good faith and not for delay, and as described above, is restricted to the grounds specified in Rule 58(2).

/s/ ORISON S. MARDEN

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